

Investment Strategies: Risks and Rewards

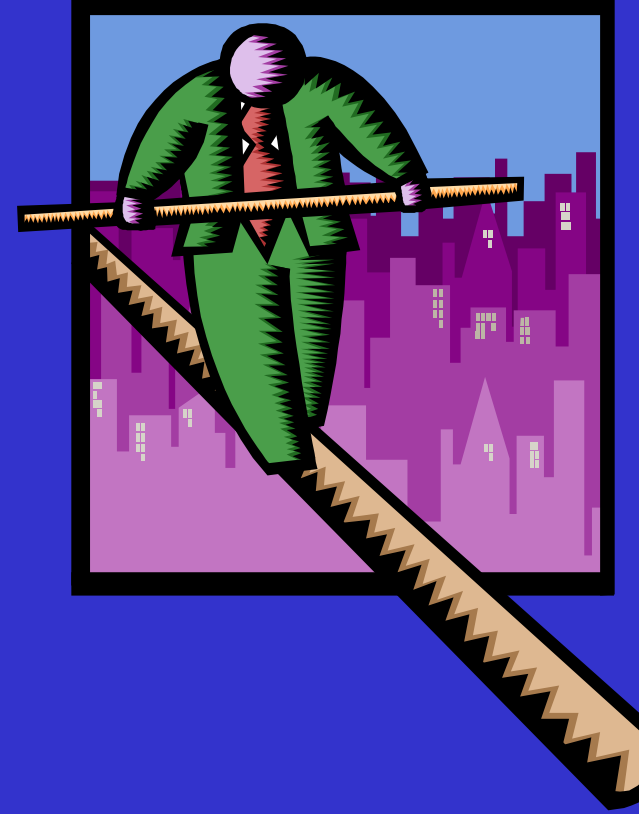
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Important Issues to Consider

- I. Potential risks and rewards of various investment strategies
- II. Impact of changing economic climate on fixed-income portfolios
- III. Management of legislative body's expectations



Investing Public Funds—A Big Responsibility

- Investing your agency's treasury is a big responsibility. You must:
 - Safeguard the funds
 - Provide ample liquidity
 - Determine and implement a prudent investment strategy
 - Manage the political ramifications of too much or too little success



Defining Risk—What Do You Consider Risky?

- Selling at a loss?

3/19/04 -- Buy UST, par: \$5.3mm, maturity: 3/31/06, yield: 2.09%

- Expected earnings to maturity = **\$214,000**

4/27/04 -- Sell UST at a loss of **(\$11,300)**

- Buy back UST 3/31/06 at 2.31%
 - Trade settles one month later, on 5/28/04
- Invest funds in commercial paper at 1.03% for one month
- Expected earnings to maturity = **\$228,200**

5/28/04 – Trade settles for UST

- Net gain on trades = **\$2,900**

Defining Risk—What Do You Consider Risky?

- Selling at a loss?
 - Investing in corporate debt?
-

Defining Risk—What Do You Consider Risky?

- Selling at a loss?
- Investing in corporate debt?
- Investing the whole portfolio in one sector?
 - All in U.S. Treasuries?
 - All in Federal Agencies?
 - All in LAIF?

Defining Risk—What Do You Consider Risky?

- Selling at a loss?
- Investing in corporate debt?
- Investing the whole portfolio in one sector?
- Purchasing callable notes?
- Buying securities with longer maturities?

Investment Strategies



Investment Strategy Considerations

- Strategy Components

- Cash flow considerations
- Tolerance for risk
 - Credit risk
 - Interest rate risk
- Duration

- Interest Rate Environment

- Rising
- Stable
- Declining
- Fluctuating within a range

Investment Priorities

Safety,
liquidity and yield.

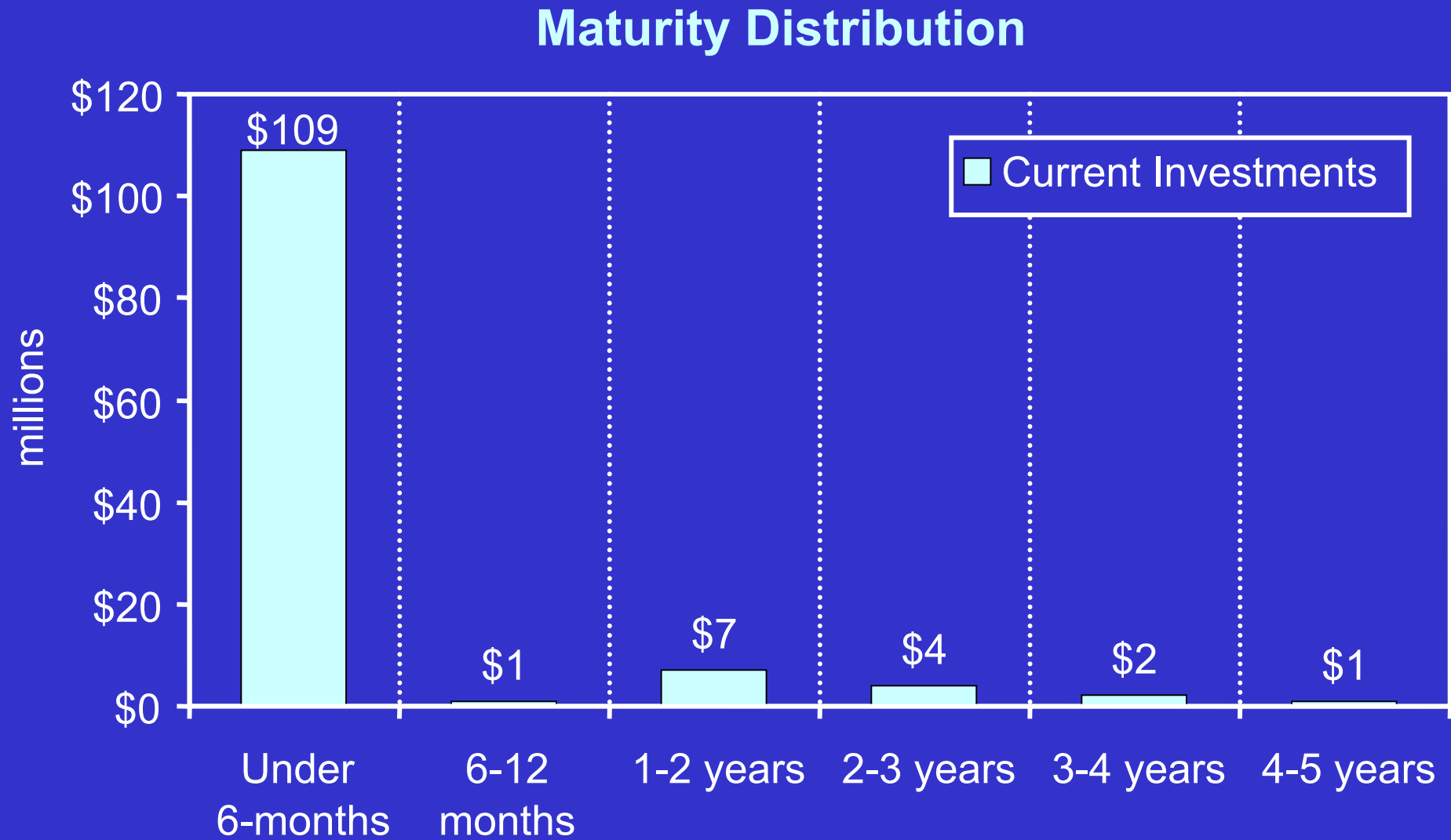
Liquidity,
safety and yield.

Yes, of course,
the priorities
are quite clear.

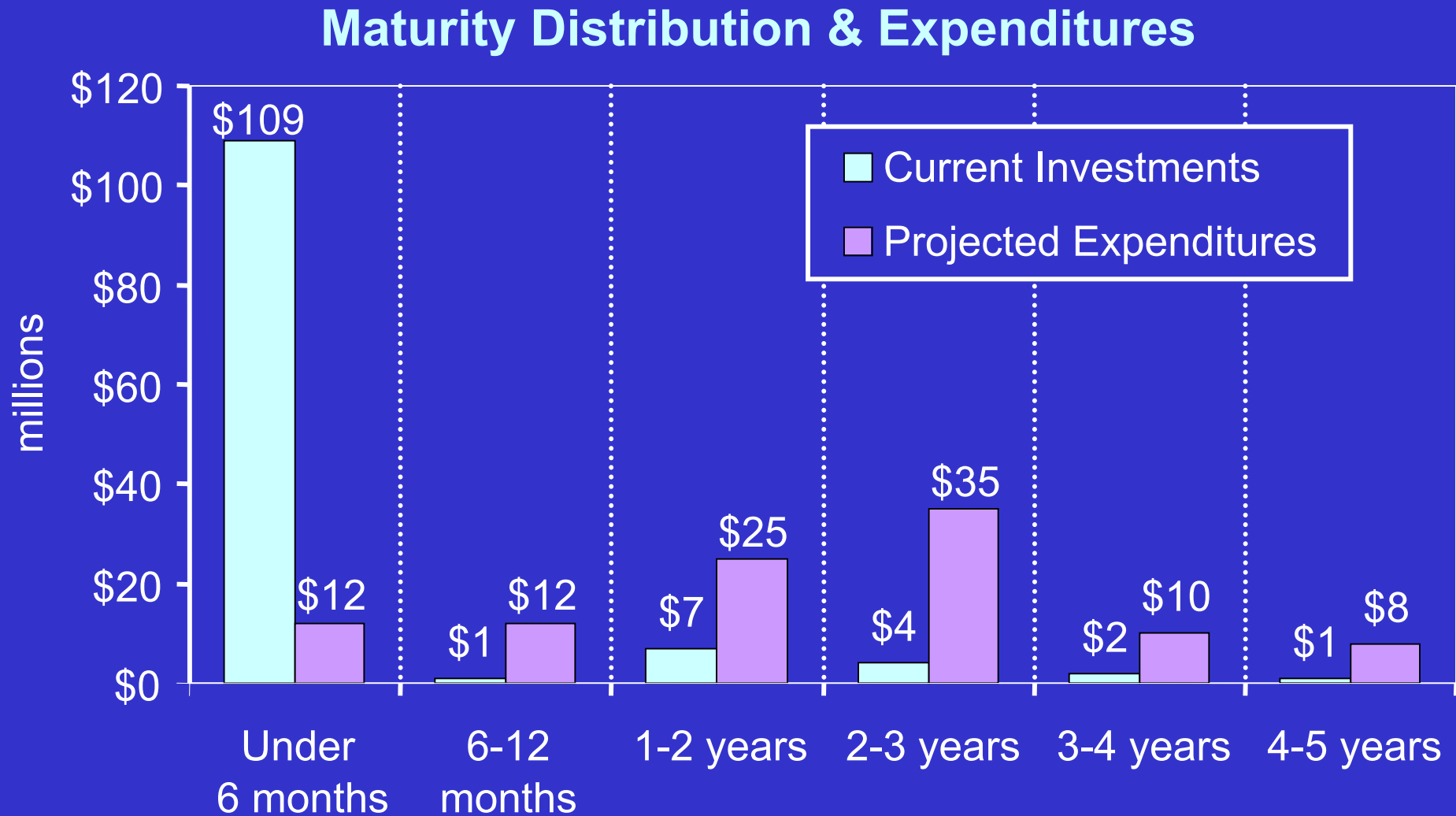
Yeah, but how
much are we
earning?



Consider Cash Flows in Investment Strategy – Sample Agency Cash Flow Schedule

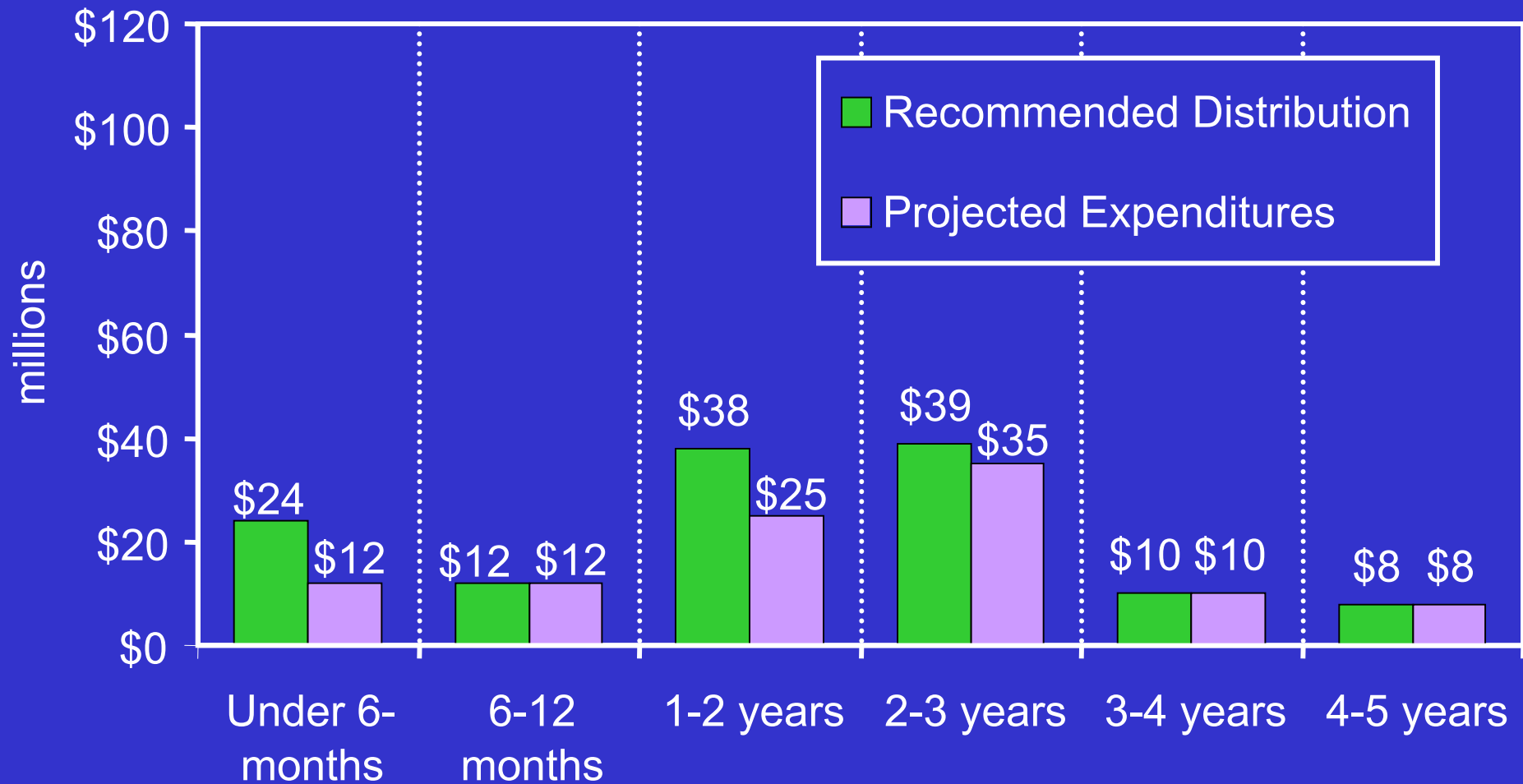


Consider Cash Flows in Investment Strategy – Sample Agency Cash Flow Schedule



Consider Cash Flows in Investment Strategy – Sample Agency Cash Flow Schedule

Maturity Distribution Recommendations



Ensure Liquidity by Using Liquid Securities

More Liquid

Pools and Mutual Funds
U.S. Treasuries
Federal Agencies Discount Notes
BAs, CDs, CP (A-1/P-1)

Federal Agencies Notes > \$50 million
Federal Agencies Notes < \$50 million
Corporate Notes/Bonds
Federal Agencies Floating Rate Notes
Corporate Medium-Term Notes (MTN)
Corporate Asset Backed Securities

Less Liquid

Federal Agencies Callable Notes
Corporate Floating Rate Notes

Municipal Securities
Reverse/Repurchase Agreements
Mortgage Backed Securities
Federal Agencies Structured Notes
Corporate Structured Notes

* In descending order of liquidity

Varying Liquidity Within Security Type

Compare Yield on Different Issue Sizes

Name	FNMA	FNMA
Maturity Date	6/15/09	6/15/09
Yield	4.37%	4.42%

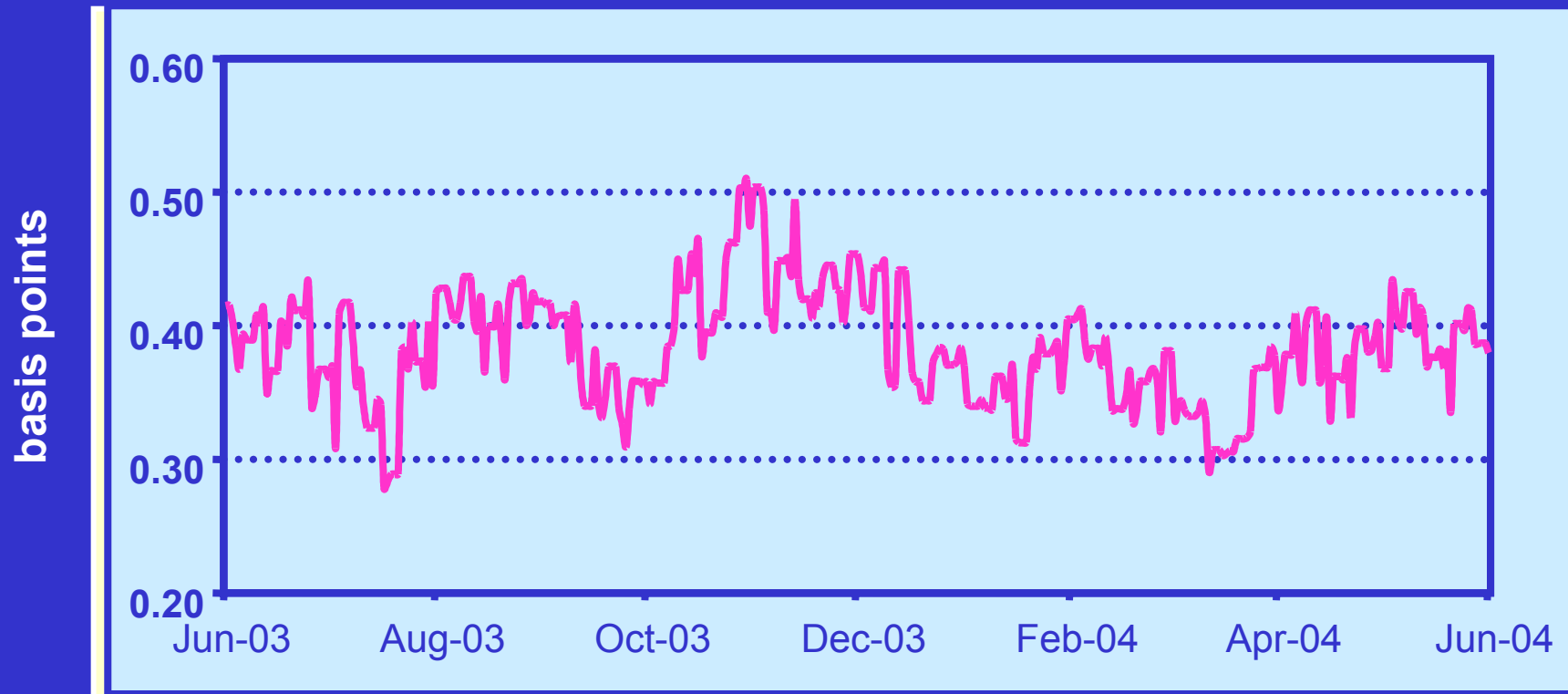
- Larger issue-size Federal Agency notes are more liquid and have slightly lower yields
 - **FHLB TAP**
 - **FNMA Benchmark**
 - **FHLMC Reference**

Risk Considerations

	U.S. Treasury	Federal Agency	Corporate
Risk Characteristics	<ul style="list-style-type: none">• AAA rated• Virtually no risk• Lower yields• Very liquid	<ul style="list-style-type: none">• AAA rated• Low risk• Intermediate yields• Liquidity varies	<ul style="list-style-type: none">• AAA – A rated• Moderate to high risk• Higher yields• Low liquidity
Short-term	Bills	Discount notes	Commercial Paper Bankers' Acceptances Certificates of Deposit
Long-term	Notes and bonds	Notes	Medium-term notes

Safely Diversify Your Portfolio

Spread Between 2 Year Treasuries and Corporates

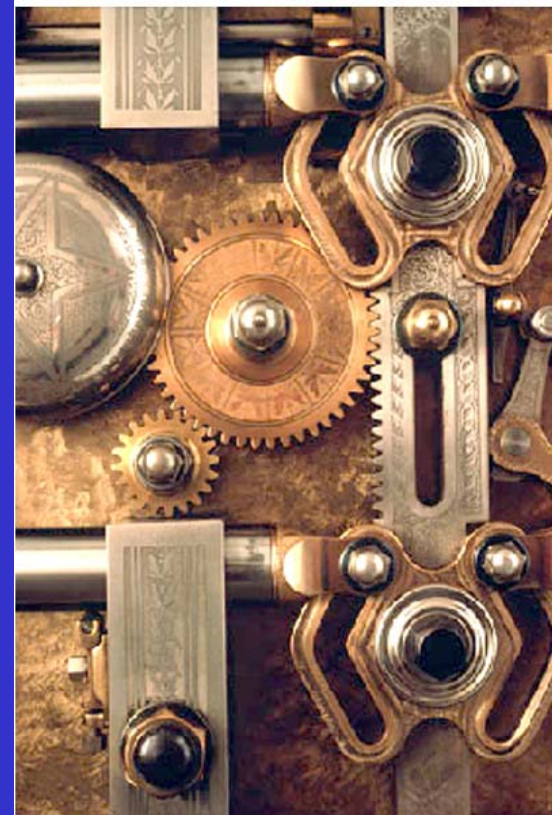


- Monitor spread trends to know when to execute a trade in a specific sector

Essential Components in Strategy Development

- Understanding your cash flows
- Ensuring adequate liquidity
 - Using short-term maturities
 - Using liquid securities
- Understanding your tolerance for risk
 - Credit
 - Maturity
 - Diversification
- Set a target duration for the portfolio

Tailoring Strategy to Economic and Market Events



Strategy for a Falling Interest Rate Environment

- Extend duration of the portfolio
- Target more of the portfolio to longer-term maturities to lock in long-term rates before they fall

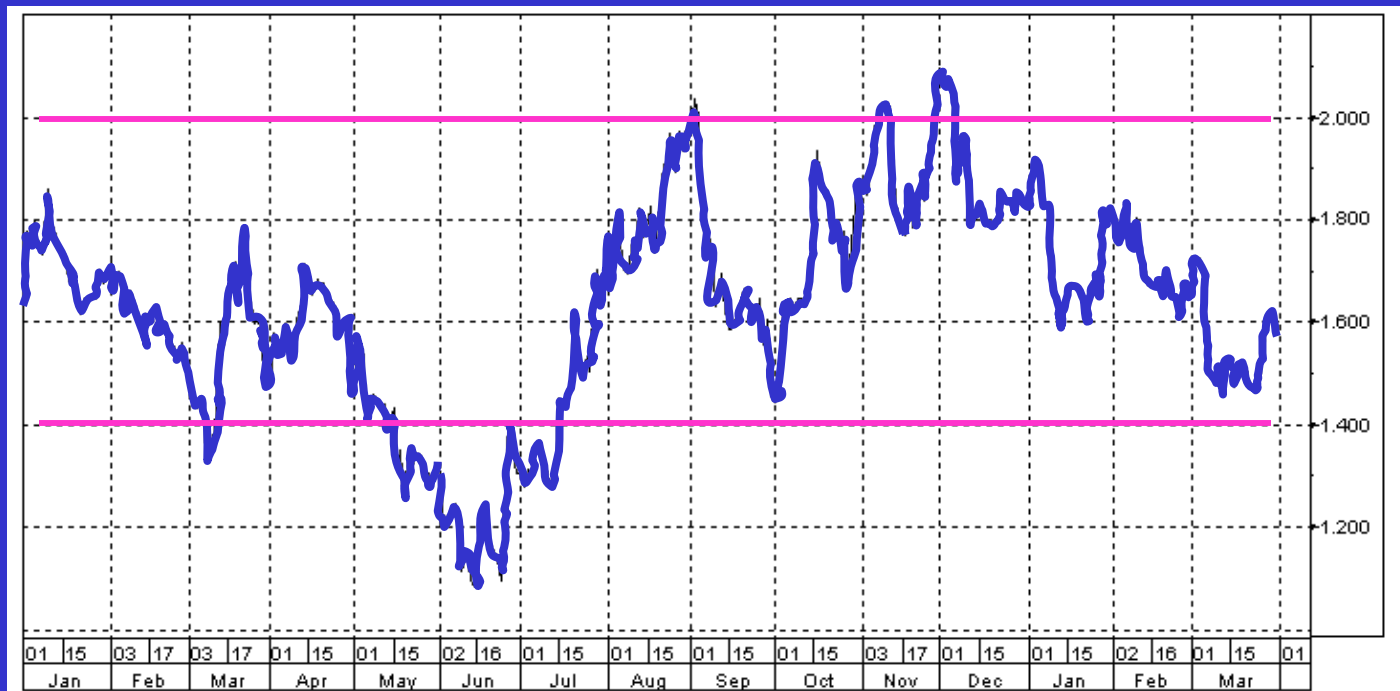
**2-Year U.S. Treasury Note
2000 - 2002**



Strategy for a Stable Interest Rate Environment

- Maintain duration near target
 - Avoid the trap of getting too liquid while waiting for rates to rise
- Concentrate investments in the steepest part of the yield curve

2-Year U.S. Treasury Yield History January 2003 – March 2004



Strategy for a Rising Interest Rate Environment

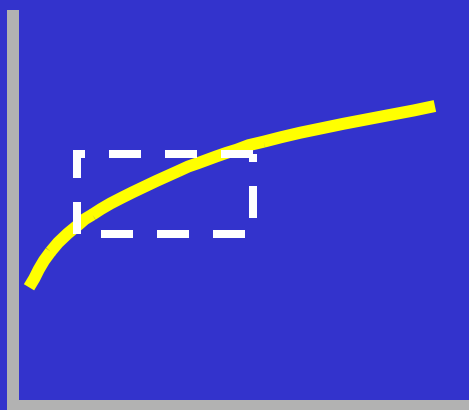
- Shorten portfolio
- Capitalize on opportunities to capture higher rates

2-Year U.S. Treasury Yield History April – June 2004

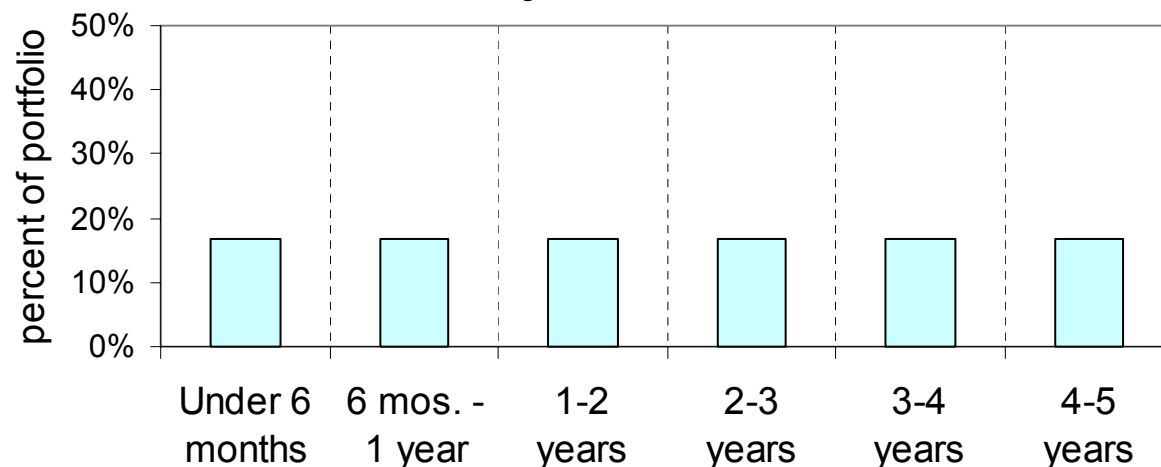


Adjusting Portfolio to Respond to Changes in the Yield Curve

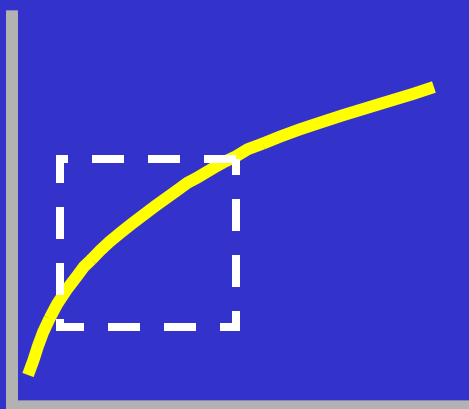
Normal Yield Curve



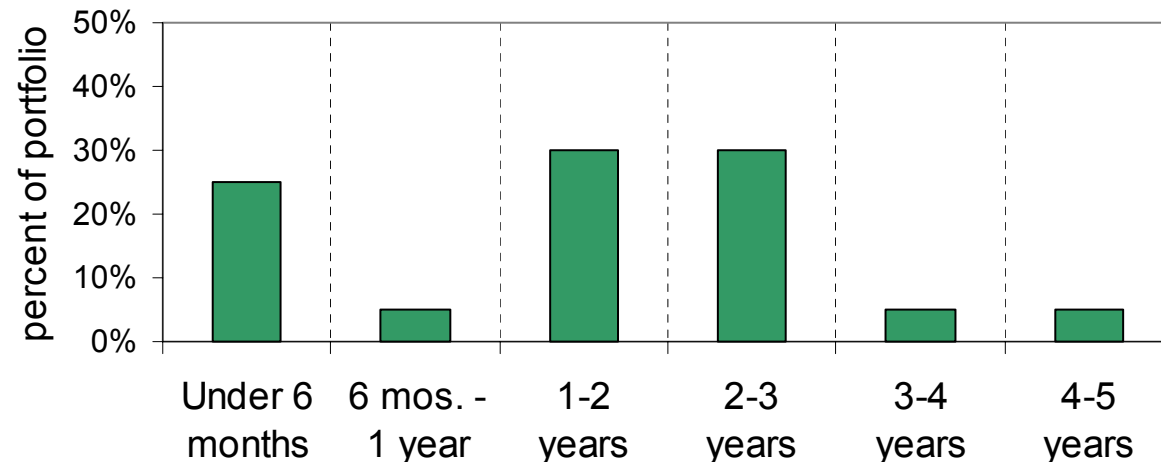
Maturity Distribution



Steep Yield Curve



Maturity Distribution

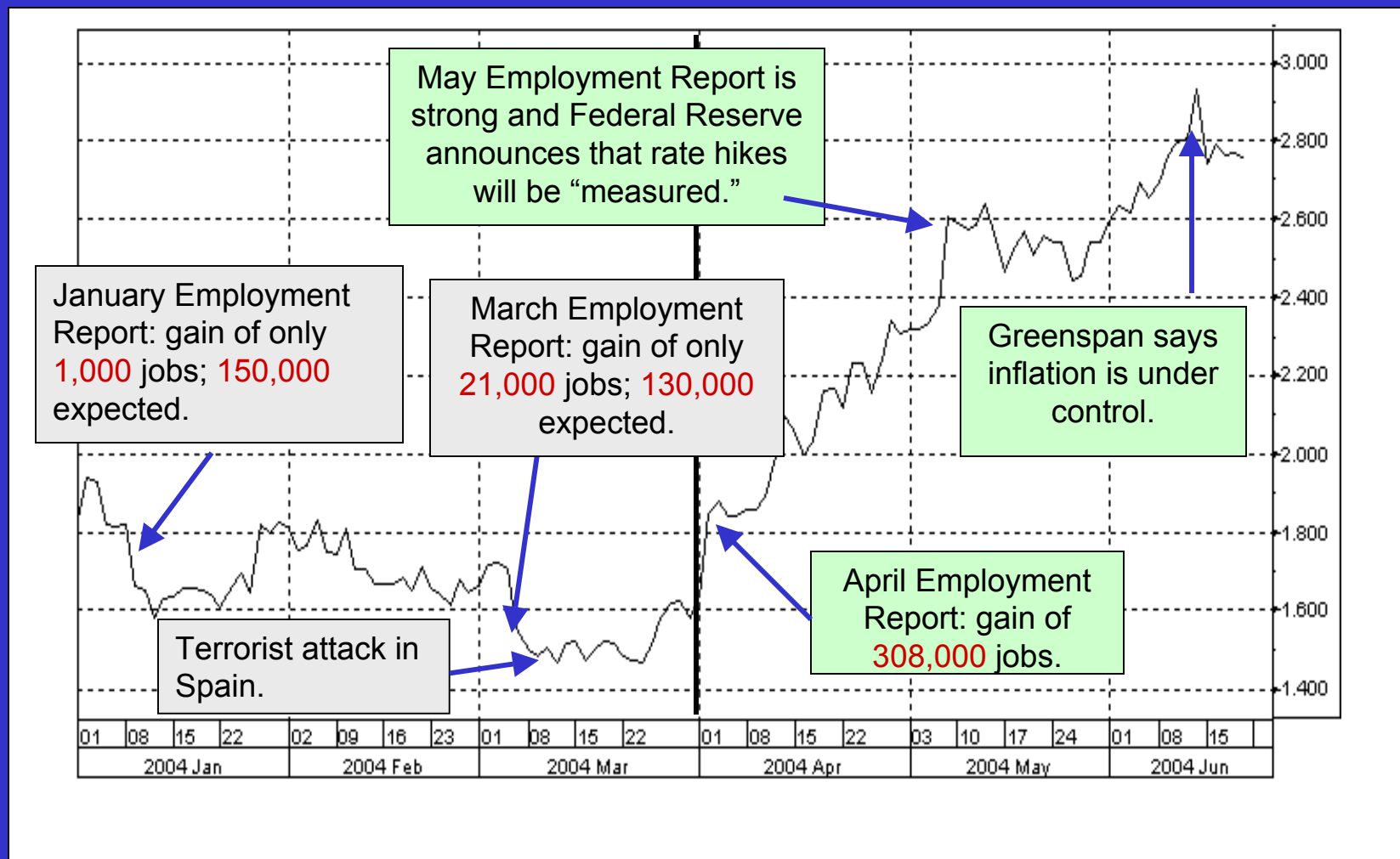


Know Where the Market Is

	Investment A	Investment B
Description	Callable Federal Agency note	Non-callable Federal Agency note
Term to Maturity	3 years	3 years
Yield	5.00%	3.00%
Total Earnings		
Actual Yield		

Stay Abreast of Market Movements and Economic Releases

2-Year U.S. Treasury Yield History January 1, 2004 – June 22, 2004



Don't Automatically Reinvest if Rates Are Unattractive

- Waiting to reinvest can allow you to ride out a low-interest rate period before locking in a long-term rate

**Yield on 2-Year U.S. Treasury Note
January 1, 2004 – April 30, 2004**



Pay Attention to Dates of Economic Data Releases

06/21/04		United States		Economic Releases			
Economic Releases							
Date/Time		Indicator		BN Survey	Actual	Prior	Revised
6/22 18:30	US 29)	ABC Consumer Confidence	(JUN 20)	--	--	-20	--
6/23 7:00	US 30)	MBA Mortgage Applications	(JUN 18)	--	--	5.6%	--
6/24 8:30	US 31)	Durable Goods Orders	(MAY)	1.5%	--	-3.2%	--
6/24 8:30	US 32)	-Less Transportation	(MAY)	1.3%	--	-2.6%	--
6/24 8:30	US 33)	Initial Jobless Claims	(JUN 19)	340K	--	336K	--
6/24 8:30	US 34)	Continuing Claims	(JUN 12)	2875K	--	2895K	--
6/24 10:00	US 35)	New Home Sales	(MAY)	1125K	--	1093K	--
6/24 10:00	US 36)	Help Wanted Index	(MAY)	39	--	38	--
6/25 8:30	US 37)	Gross Domestic Product	(1Q F)	4.4%	--	4.4%	--
6/25 8:30	US 38)	Personal Consumption	(1Q F)	3.9%	--	3.9%	--
6/25 8:30	US 39)	GDP Price Deflator	(1Q F)	2.6%	--	2.6%	--
6/25 9:50	US 40)	U. of Michigan Confidence	(JUN F)	95.0	--	95.2	--
6/25 10:00	US 41)	Existing Home Sales	(MAY)	6.50M	--	6.64M	--
6/28 8:30	US 42)	Personal Income	(MAY)	0.5%	--	0.6%	--

Pay Attention to Corporate Names in the News



SEC Probes

Chapter 11 Bankruptcy



Accounting Investigations



Credit Ratings Downgrades



Monitor News In Corporate Sectors In Your Portfolio

Southern California Edison: A Cautionary Tale

- In mid-2000, we began to experience the energy crisis in California with soaring electricity prices and rolling blackouts

Timeline of the Bankruptcy

Dec 10, 2000

Moody's P-1

S&P A-1

Jan 19, 2001

SCE Defaults

Dec 11, 2000

Moody's places
SCE on Negative
CreditWatch

Dec 13, 2000

S&P places SCE
on Negative
CreditWatch

Jan 4 & 5, 2001

Downgraded to
A-3/P-3

Selling Securities Prior to Maturity

- Selling securities is not speculative
- Reasons to sell a security before maturity
 - Increase liquidity to the portfolio
 - Realize a market value gain
 - Rolling down the yield curve
 - Improve the portfolio
 - Improve credit quality
 - Increase diversification
 - Sector
 - Issuer
 - Get a dog out of the portfolio

Politics of Portfolio Management



Every dollar is
getting the squeeze!

Samples of Questions from Governing Bodies

How can you have budget problems with so much in the bank?

The real estate market is taking off...Why don't we have any property holdings in our portfolio?

How much have we got in stock and mutual funds?

I trust LAIF....Why don't we deposit the whole portfolio into LAIF?



New Pressures on Interest Income

- As revenues have tightened, governing bodies are looking to the portfolio for needed income



Let's invest everything in 5-year securities, since they have the highest yield.

Educating Non-Finance Officials about the Portfolio

- Educate non-finance officials about the overall investment strategy and the current market
 - Steep part of the yield curve
 - Callable securities
 - Selling at a loss
 - Performance
 - Benchmarks
- Initiate brown-bag lunches to train on various topics



Use a Pragmatic Approach

- Don't buy what you don't understand—even if it offers a great yield
 - Step-ups to fixed
 - Specially-tailored structures from Federal Agencies
 - Asset-backed securities



Manage Political Risks By Using Available Tools

- Investment policy
- California government code
- Approved broker/dealers list
- Internal controls
- Investment committee

